Why It Pays to Spend More Time on the ~~Time~~ Term Sheets

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Most commercial real estate transactions start with a term sheet. The parties and a broker or two summarize the basic terms of the deal in two or three pages. The term sheet identifies the property in question, the parties, and the basic economic terms. And we're good to go.

Not necessarily. Term sheets can justify more attention than that, for at least two reasons.

First, if they leave out some "magic language," they expose the parties to the risk of liability under a transaction that they did not regard as final or legally binding. That liability can take the form of a claim from the potential counterparty or from one of the brokers who might decide they earned a commission.

It's fairly easy to prevent that exposure. Competent brokers often have standard language they include in term sheets to solve the problem. Lawyers may have even better language.

The second reason to spend more time on term sheets is that they provide an excellent opportunity to prevent issues in the final deal documents. This is where the lawyers need to come in, and why it often makes sense to have counsel review a term sheet.

In any transaction, a handful of legal issues will arise. If the term sheet doesn't address them, then the draft transaction documents usually will.

By the time the parties start to circulate draft documents, both parties are "committed" to the deal – psychologically at least. When those legal issues arise in the final transaction documents, they blossom forth in full glory – three pages of assignment restrictions, seventeen paragraphs of burdensome construction document procedures, approval requirements for practically everything, with conforming provisions throughout the entire document and perhaps multiple documents.

Once those unfavorable provisions have taken root in the document set, it's harder to eliminate them than it would have been to nip them in the bud in the term sheet. At that early stage, we all know what those unfavorable provisions will be, so it makes sense to undertake some preventive negotiations.

The provisions that cause trouble typically do not involve basic economics, but instead a collection of issues that can become major once they arise in the actual documents. Those issues usually relate to such things as transfer restrictions, approval rights, future flexibility, contingent payments, and practical requirements or restrictions relating to business operations. In addition, for a loan, the most common gap in a term sheet arises when the parties say the loan documents will contain "standard" nonrecourse carveouts, rather than spelling out what they mean by that.

These issues are not often obvious. They often involve the failure to say something – silence – rather than some provision that already appears in the term sheet and invites a response. Someone needs to think of raising these issues at the term sheet stage. And that "someone" will probably be a lawyer who has negotiated dozens of similar transactions and knows where the problems will arise.

Thus, even in the heat and excitement of negotiating a term sheet, it will often make sense to ask counsel to take a look. That process will almost always suggest provisions to try to include in the term sheet. And if the other side refuses to budge on those issues, that can be very useful information, especially if those issues are dealbreakers. The discussion may make it clear that the deal just won't work, and it's time to look for a different counterparty. The best time to learn that, of course, is at the term sheet stage rather than after a month spent negotiating documents and passing up other opportunities.

For office lease negotiations, I've prepared and made available online a checklist of issues that a tenant might want to raise at the term sheet stage. Most of those issues won't apply to any given lease, but they might help the tenant focus on what issues do merit raising in the term sheet. For a copy of that checklist, visit www.documentcenter.us (no registration required).

Sometimes it might make sense to agree in the term sheet that whoever prepares the first draft of documents will work from a fully negotiated set of documents from another transaction, even if it involved other parties. If the previous transaction involved the same parties, then of course it goes without saying that one would use the fully negotiated documents from last time. If the parties do agree to start from negotiated documents, then perhaps the term sheet should also include a commitment to try to minimize comments on those documents. Whether any of the measures suggested in this paragraph will actually improve the negotiation process is unknowable, and reasonable people differ.

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